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COORDINATED ISSUE
MEDIA/COMMUNICATIONS INDUSTRY
TRANSITION PROPERTY

ISSUE

Are the specifications and amount of cable television property readily ascertainable from the terms of the cable television franchise or related documents as of December 31, 1985, so that the property may qualify for the investment tax credit and the Accelerated Cost Recovery System ("ACRS") depreciation deduction under the supply or service contract transition rule of section 204(a)(3) of the Tax Reform Act of 1986?

FACTS

A cable television company operates several cable television systems in certain geographic areas. A system consists of a group of contiguous franchises.
The operating company asserts that cable television franchise agreements are service agreements that require it to construct a cable system consisting of distribution trunk lines, subscriber drops, and converters. In general, the company hires contractors to perform all of its construction work, both the initial installation and the rebuilds of the cable distribution system. The company installs subscriber drops and converters itself. To direct construction work, the company provides a strand map to the contractor and highlights on the map where construction work is to be performed. Upon completion of the work, the contractor submits an invoice which the company approves. The contractor marks the map upon completion of a construction area.
A cable television franchise agreement often places the following requirements upon a cable television operator:

a. For a new system, the franchise agreement may require that the cable distribution system be constructed in a specific area by a specific date. In addition, the cable distribution system is often required to be extended to any area where a certain density of homes per mile of distribution system is met.

b. If an area (neighborhood, subdivision, etc.) meets future density requirements described in (a), then the cable operator is required to extend the cable distribution system to that area. Most line extensions are built within six months of completion of design work.

c. The cable distribution system must conform with Federal Communications Commission (FCC) regulations. FCC regulations

may mandate a rebuild of the cable system if the system fails to meet certain technical specifications. To ascertain whether rebuilding is necessary, the Taxpayer must routinely inspect the cable system for signal leakage, signal level, signal to noise ratio, and amplitude versus frequency. The Taxpayer prepares a cumulative signal leakage index in accordance with FCC technical regulations. When the aforementioned data indicates that plant must be rebuilt, the Taxpayer begins field mapping of every foot of cable plant in areas requiring rebuilding. The Taxpayer correlates the mileage determined by this mapping process with its existing records to determine the exact area which must be rebuilt.

d. The cable television franchise implies that a cable television operator is required to provide cable television services to any household within the service area, if the household requests the service. Whether a subscriber drop or converter is required pursuant to the franchise agreement at any point in time cannot be determined from the franchise agreement alone. Related documentation in the form of customer orders, subscriber contracts, etc., are necessary to determine when, where, and if subscriber drops and converters are required pursuant to the franchise agreement.

Cable television operators possess monthly records of households requesting service. The installation of service to an individual household requires a subscriber drop and frequently a converter. The converters and drops are usually installed within two weeks of a subscriber request for service.

Cable television operators capitalize the costs of the system, claim investment tax credit and apply the ACRS to this property based solely on the date the franchise was granted even though the property was placed in service in years after 1985 for investment tax credit, and after 1986, for ACRS.

LAW

Section 38(a) of the Internal Revenue Code provides for a general business credit against tax that includes the amount of the current year business credit. Section 38(b)(1) provides that the current year business credit includes the investment credit determined under former section 46(a). Former section 46(a) provides that for purposes of section 38, the amount of the investment credit for any taxable year shall be an amount equal to the sum of certain specified percentages. Former section 48(a) identifies the categories of property eligible for the credit.

Former section 49(a) of the Code, as added by section 211(a) of the Tax Reform Act of 1986 ("Act"), provides that the 10 percent regular investment credit does not apply to property placed in service after December 31, 1985. Former section 49(b)(1) provides that the repeal does not apply to "transition property" as defined in former section 49(e), subject to the general limitations in former sections 49(c) and (d).

Former section 49(e)(1) of the Code defines the term "transition property" as any property placed in service after December 31, 1985, and to which the amendments made by section 201 (which modified the accelerated cost recovery system) of the Tax Reform Act of 1986 do not apply, except that in making the determination, section 203(a)(1)(A) of the Act shall be applied by substituting "1985" for "1986", and sections 203(b)(1) and 204(a)(3) of the Act shall be applied by substituting "December 31, 1985", for "March 1, 1986." In addition, certain placed in service dates apply depending upon the class life of the transition property.

Section 203(b)(1)(A) of the Act provides the general transitional rule, commonly referred to as the "binding contract" rule. According to this rule, transition relief is afforded to any property that is constructed, reconstructed, or acquired by the taxpayer pursuant to a written binding contract that was binding on December 31, 1985. The Conference Committee Report for the Act, 2 H.R. Rep. No. 99- 841 (Cong. Rep.), 99th Cong., 2d Sess. II-54, 1986-3 (Vol.4) C.B. 54, in explaining the general binding contract transitional rule provides, in part, that the repeal of the investment credit and modification of ACRS does not apply to property subject to binding contracts, but that the rule "applies only to contracts in which the construction, reconstruction, erection, or acquisition of property is itself the subject matter of the contract." Further, a contract is binding only if it is enforceable under state law against the taxpayer, and does not limit damages to a specified amount (e.g., by use of a liquidated damages provision). [Conf. Rep. at II-55].

Section 204(a)(3) of the Act provides an additional transitional rule for property that is readily identifiable with and necessary to carry out a written supply or service contract, or agreement to lease, that was binding on December 31, 1985.

The conference report in explaining this provision states, in part that:

> [t]he bill provides transitional relief for certain situations where written binding contracts require the construction or acquisition of property, but the contract is not between the person who will own the property and the person who will construct or supply the property. This rule applies to written service or supply contracts and agreements to lease entered into before March 2, 1986, (January 1, 1986, in the case of the investment tax credit) . . . The conferees wish to clarify that this rule applies to cable television franchise agreements embodied in whole or in part in municipal

> ordinances or similar enactments before March 2, 1986 (January 1, 1986, for the investment tax credit).
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> This transition rule is applicable only where the specifications and amount of the property are readily ascertainable from the terms of the contract, or from related documents. A supply or service contract or agreement to lease must satisfy the requirements of a binding contract (discussed above). [Conf. Rep. at II 59- 60]. (Emphasis added).

DISCUSSION

The cable television operator's position is that all cable television franchise property installed pursuant to a cable franchise agreement in existence as of December 31, 1985, should automatically qualify as property "readily identifiable with and necessary to carry out" the terms of a franchise agreement that was binding on December 31, 1985, under section 204(a)(3) of the Act. The cable television operator believes that the meaning of the wording of section 204(a)(3) is clear and warrants such an interpretation.

The Service does not agree with the operator's interpretation of the transition rule under section 204(a)(3). Section 204(a)(3) provides transitional relief only to "property which is readily identifiable with and necessary to carry out" a written supply or service contract, or agreement to lease, which was binding on December 31, 1985. The Taxpayer's expansive interpretation would provide transitional relief to all property necessary to carry out a service contract without regard to the additional requirement that the property be readily identifiable with the service contract.

The legislative history underlying this provision clarifies that transitional relief is applicable only where the "specifications and amount of the property are readily ascertainable from the terms of the contract or related documents." It should be noted that the specifications and amount of the property necessary to carry out a service contract generally are not ascertainable from such a contract in contrast to property the construction or acquisition of which is itself the subject matter of the contract. In light of this lack of specificity, we believe that Congress by enacting section 204(a)(3) with the stipulation that property be "readily identifiable with", sought to provide an added measure of certainty by requiring a taxpayer to have more specific information with which to identify property necessary to carry out a service contract. Accordingly, for purposes of the transition rule, under section 204(a)(3) of the Act, property necessary to carry out the cable television franchise agreement will be treated as readily "identifiable with" the franchise agreement only if the specifications and amount of the property are readily ascertainable from the franchise agreement or related documents. However, the Service does not believe that a cable television

operator's future projections of cable television service for the franchised area or the parameters set forth in a cable television franchise agreement (outlining the circumstances under which cable service would be required), provide the requisite specificity contemplated by Congress.

Based on the foregoing statutory language and legislative history, the Service has concluded that a cable television franchise agreement is not binding as of December 31, 1985, with respect to property placed in service by a taxpayer after December 31, 1985, pursuant to the franchise agreement, unless the specifications and amount of such property are "readily ascertainable from the terms of the contract or related documents." Related documents in the case of a cable television franchise would include:

a. Construction design plans and construction contracts for line extensions;

b. Customer service orders, customer lists, subscriber contracts, etc., that indicate when a customer has requested cable service requiring subscriber drops and converters;

c. FCC reports, engineering studies, field mapping reports, etc., that would indicate that a rebuild is mandated in accordance with FCC regulations; and

d. Equipment purchase orders.

In the case of cable line extensions, the specifications and amount of cable extension property will be treated as readily ascertainable from the terms of franchise agreement or related documents (construction design plans, construction contracts, or work orders) only if documentation in existence as of December 31, 1985, reveals details about line extensions associated with new subdivisions, in compliance with requirements in a franchise agreement binding on December 31, 1985.

In the case of rebuilds, the specifications and amount of property will be treated as readily ascertainable from the franchise agreement (or related documents) only if the property is with respect to a cable plant system for which there is field mapping (or other documentation indicating that specific rebuilds are required) in existence as of December 31, 1985, pursuant to a cable franchise agreement binding on December 31, 1985.

In the case of drops and converters, the specifications and amount of property will be treated as readily ascertainable from the franchise agreement (or related documents) only with respect to property for which there is documentation that subscribers

requested service prior to December 31, 1985, pursuant to a cable franchise agreement binding on December 31, 1985.

CONCLUSION

To the extent that a cable television operator fails to demonstrate that the specifications and amount of claimed transition cable television property are readily ascertainable from the cable franchise agreement or related documents, the operator will not qualify for investment tax credit and ACRS depreciation deductions under the supply or service contract transition rule of section 204(a)(3) of the Tax Reform Act of 1986.